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DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 94-0893 ITC
Gross Income Tax
For Tax Periods: 1985 and 1988 through 1992

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ISSUES

I. Gross Income Tax — Receipts from Retail Sales

Authority: IC 6-2.1-2-1

Taxpayer protests assessments of Indiana gross income tax on sales of tangible personal property from inventory.

II. Gross Income Tax — Receipts from "Remanufacturing" Activities

Authority: IC 1-1-4-1; IC 6-2.1-2-1; IC 6-2.5-4-2; IC 6-6-2.5-12
45 IAC 1.1-1-23; 45 IAC 2.2-5-10
Jefferson Smurfit v. Indiana Department of State Revenue, 681 N.E.2d 806 (Ind.Tax 1997);
Chrome Deposit v. Indiana Dept. of State Revenue, 557 N.E.2d 1110 (Ind.Tax 1990);
State v. Apex Steel & Supply Company, 375 N.E.2d 598 (Ind.App. 1978);
Oster v. Department of Treasury, 37 N.E.2d 528 (Ind. 1941).

Taxpayer protests assessments of Indiana gross income tax on receipts derived from "remanufacturing" activities.

III. Gross Income Tax — Interstate Sales

Authority: IC 6-2.1-3-3; IC 6-8.1-5-1
45 IAC 1-1-119

Taxpayer protests the characterization of its "out-of-state sales" as Indiana gross income.

STATEMENT OF FACTS

Taxpayer is incorporated and domiciled in Indiana. For tax years 1985 and 1988 through 1992, Audit proposed assessments of Indiana gross income tax. Taxpayer protested these assessments. The Department held an administrative hearing and a Letter of Findings (LOF) was subsequently issued. As Taxpayer was not sustained on all protested issues, Taxpayer timely requested, and the Department granted, a rehearing.

I. Gross Income Tax — Receipts from Retail Sales

DISCUSSION

Among its business activities, Taxpayer *remanufacturers* certain types of rings. Remanufacturing activities require Taxpayer to obtain a supply of used rings. Taxpayer may purchase used rings from third parties. Taxpayer may accept used rings from customers which are given as "trade-ins" towards the purchase of new or remanufactured rings; or Taxpayer may receive used rings from its customers, not as trade-ins, but with instructions to "remanufacture" and return the originally supplied rings.

Taxpayer's original protest focused on whether, for gross income tax purposes, receipts from remanufacturing activities should have been taxed at the high rate (as service sales) or at the low rate (as retail or wholesale sales).

In the original letter of findings ("LOF"), the Department concluded that Taxpayer's sale of remanufactured rings *from inventory* qualified for low rate treatment because the receipts were derived from selling at retail. The Department explained:

> Consistent with the…language [found in IC 6-2.1-2-1(b)(1)], **taxpayer's sale of remanufactured rings *from inventory* qualifies as selling at retail.**

Conversely, the Department also stated:

> *[But] when taxpayer's customers send in used rings and receive, in return, their original, remanufactured rings, receipts from these sales are not derived from "selling at retail."* Absent from these transactions is the requisite exchange of tangible personal property.

To summarize, the Department concluded that Taxpayer's sales of remanufactured rings *from inventory* qualified for low rate treatment while receipts from "sales" of remanufactured rings owned by its customers were to be taxed at the high rate. The Department denied Taxpayer's protest.

Taxpayer asks the Department to clarify the scope of its original findings. Specifically, Taxpayer is concerned that despite the language used in the original LOF, the unconditional denial of Taxpayer's protest results in additional gross income tax assessments, at the high rate, for receipts derived from sales of remanufactured rings from inventory.

Taxpayer points to the Department's own language in the original LOF:

> Audit classified taxpayer's remanufacture of jet engine rings as a service activity. Consequently, **Audit assessed all income received from these remanufacturing activities at the high rate for gross income tax purposes** (emphasis added).

Taxpayer contends the aforementioned language, coupled with language found in the auditor's report, indicates that all receipts derived from remanufacturing activities—whether from sales of remanufactured rings from inventory, or from "sales" of remanufactured rings owned by its customers—were classified by Audit as service income.

Taxpayer's point is well taken. The language used by Audit does suggest that all receipts from Taxpayer's remanufacturing activities were characterized as high rate service income—a result at odds with the conclusions reached by the Department. The proposed assessments, therefore, will be adjusted to the extent Taxpayer's retail sales (i.e., sales from inventory) were mistakenly characterized as service income.

FINDING

Taxpayer's protest is sustained.

II. Gross Income Tax — Receipts from "Remanufacturing" Activities

In the original protest, Taxpayer argued that its remanufacturing activities should have been characterized, for gross income tax purposes, as industrial processing—with receipts taxed at the low rate. Taxpayer, in support of its position, directed the Department's attention to IC 6-2.1-2-1(c)(1)(D)(ii), which broadened the statutory definition of wholesale sales to include:

> (D) Receipts from industrial processing or servicing, including:
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> (i) tire retreading; and
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> (ii) the enameling and plating of tangible personal property which is owned and is **to be sold** by the person for whom the servicing or processing is done, either as a complete article or incorporated as a material, or as an integral or component part of tangible personal property **produced for sale** by such person in the business of manufacturing, assembling, constructing, refining, or processing (emphasis added).

The court in *Jefferson Smurfit v. Indiana Department of State Revenue,* 681 N.E.2d 806 (Ind.Tax 1997), limited application of the industrial processing resale requirement (i.e., the "to be sold" and "produced for sale" language) to only those engaged in "enameling and plating" activities.

Given this "limitation," Taxpayer believed its remanufacturing activities fell within the industrial processing classification.

The Department disagreed, and explained:

> [R]egardless of moniker used – whether taxpayer rebuilds, repairs, refurbishes, or remanufactures – taxpayer's customers are not engaged in activities contemplated by the concept, or definition, of "industrial processing." **Implicit in the concept of industrial processing is the notion that the owners of the processed property (i.e., taxpayer's customers) are engaged in manufacturing, processing, or similar activities**. In this instance, taxpayer's customers—commercial airlines—are not engaged in these types of activities. Rather, taxpayer's customers are service providers (emphasis added).

Taxpayer asks the Department to reconsider its interpretation of "industrial processing" in light of the *Jefferson Smurfit* decision. Taxpayer provides the following rationale:

> As the Jefferson Smurfit court dictates, subsections of IC 6-2.1-2-1(c)(1)(D) must be read independently. Borrowing from the rationale of the Jefferson Smurfit court, a similar conclusion is reached regarding the "by such person in the business of manufacturing, assembling, constructing, refining, or processing" requirement contained in subparagraph (ii). This requirement may not be expanded beyond the parameters of (ii). If the restrictions in (ii) do not apply to (i), they certainly do not apply to subsection (D) in general….Only "industrial processing or servicing" that involves enameling and plating, and which falls under Ind. Code Ann. 6-2.1-2-1(c)(1)(D)(ii), may have a "by such person in the business of manufacturing, assembling, constructing, refining, or processing" requirement. Therefore, [Taxpayer], whose industrial processing or servicing does not involve enameling or plating, has no "such person in the business of manufacturing, assembling, constructing, refining, or processing" requirement for the years in question, 1990-1992.

In other words, Taxpayer argues that since the "to be sold" and "produced for sale" language (aka the "resale" requirement) applies only to those engaged in "the enameling and plating of tangible personal property," so too should the phrase "by such person in the business of manufacturing, assembling, constructing, refining, or processing."

The Department disagrees with Taxpayer's conclusions and therefore, declines the invitation to revise its post-*Jefferson Smurfit* interpretation of IC 6-2.1-2-1(c)(1)(D)(ii). If, as Taxpayer contends, the logic used by the *Jefferson Smurfit* court to limit the resale requirement to only those "engaged in enameling and plating of tangible personal property" can be used to similarly limit the rest of the requirements listed in IC 6-2.1-2-1(c)(1)(D)(ii), then what remains of the concept "industrial processing?"

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While the term is not ubiquitous, a discussion (however brief) of "industrial processing" appears in enough Indiana authorities—e.g., statutes, regulations, and court cases—to indicate the term's ongoing relevance and importance. The term "industrial processing" is explicitly mentioned in **four (4) Indiana court cases**—*Jefferson Smurfit, Chrome Deposit v. Indiana Dept. of State Revenue,* 557 N.E.2d 1110 (Ind.Tax 1990), *State v. Apex Steel & Supply Company*, 375 N.E.2d 598 (Ind.App. 1978), and *Oster v. Department of Treasury*, 37 N.E.2d 528 (Ind. 1941)—**three (3) statutes**—IC 6-2.1-2-1 (imposition of gross income tax), IC 6-2.5-4-2 (state gross retail and use taxes, "wholesale sales"), and IC 6-6-2.5-12 (definition of "heating oil")—and **two (2) regulations**—45 IAC 1.1-1-23 (gross income tax, "wholesale sale" defined) and 45 IAC 2.2-5-10 (sales and use tax exemptions).

However, after *Jefferson Smurfit*, who may call themselves "industrial processors" except those engaged in enameling and plating activities? Do the following requirements of IC 6-2.1-2-1(c)(1)(D)(ii), as Taxpayer argues, now apply only to this select subset of "industrial processors" and not to those who have traditionally been characterized as "industrial processors?" Taxpayer wishes to limit the following language:

1. the tangible personal property being processed must be owned "by the person for whom the servicing or processing is done;"

2. the tangible personal property being processed or serviced must either represent **(a)** a complete article or **(b)** one incorporated as a material, or **(c)** integral, or **(d)** component part of tangible personal property; and

3. the owner of the property (i.e., the "industrial processor's customer) must be in the business of **(a)** manufacturing, **(b)** assembling, **(c)** constructing, **(d)** refining, or **(e)** processing.

At first blush, parity of reasoning suggests Taxpayer may be correct. But absent a statutory definition of "industrial processing," how can the Department properly administer the statute?

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Without a definition of "industrial processing," only those engaged in enameling and electroplating could qualify for low rate treatment. IC 6-2.1-2-1. All others (including Taxpayer) would, by default, be characterized as "service providers"—an absurd result clearly at odds with and "plainly repugnant" to the intent of the Legislature as evidenced by the aforementioned authorities.

Therefore, absent a statutory definition of "industrial processing"—a conclusion reached if Taxpayer's post-*Jefferson Smurfit* interpretation is correct—the term "industrial processing" must be given its "plain and ordinary meaning." (See IC 1-1-4-1 and *Apex Steel.*) To obtain such meaning, the Department must turn to other sources.

The court in *Apex Steel* was required to define "processing" and "servicing" as the words were used in a previously codified version of the statute defining "wholesale sales." The court stated:

> At issue is the interpretation of IC 6-2-1-3, and in particular subparagraphs (a)(4) and (g). Subparagraph (a)(4) provides a tax rate of ½% upon wholesale sales. "Wholesale sales" are then specially defined in seven (7) categories. Category (4) consists of,
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> > [r]eceipts received from the business of industrial **processing** or **servicing** including but not limited to enameling and plating of any tangible personal property…(emphasis added).

Apex Steel at 598.

The court, interpreting the words "servicing" and "processing" as used in IC 6-2-1-3(a)(4), adopted the following definition:

> As Apex's expert witness in linguistics testified at trial, "processing" and "servicing" in their plain and commonly understood meaning refer to *performing some act upon a material in order to render it in a condition for further use, or for sale or into a finished state* (emphasis added).

Id. at 600.

However, our lexical analysis is not complete as both "processing" and "servicing" are modified by "industrial." The Department references a popular English language dictionary—*The American Heritage Dictionary of the English Language* (Third Edition, 1992)—in its search for the "plain and ordinary meaning" of "industrial." As an adjective, "industrial" means "relating to, or resulting from industry: *industrial development; industrial pollution*." *Id.* at 922. The first three (3) definitions for "industry" read as follows:

> **1.** Commercial production and sale of goods. **2.** A specific branch of manufacture and trade: *the textile industry*. See synonyms at **business. 3.** The sector of an economy made up of manufacturing enterprises: *government regulation of industry*.

Id.

As "industry" refers to those engaged in production or manufacturing activities, so too must "industrial." Even absent a statutory definition of "industrial processing," its plain and common meaning suggests a reference to one who performs "some act upon [tangible personal property] in order to render it in a condition for further use, or for sale or into a finished state" for another who is engaged in production or manufacturing activities. The "by such person in the business of manufacturing, assembling, constructing, refining, or processing" requirement of IC 6-2.1-2-2(c)(1)(D)(ii) is consistent with this "plain and ordinary" meaning.

Not only is the "plain and ordinary meaning" consistent with commonsense perceptions of "industrial processing," it is consistent with the term as it is used in the context of a statutory subset of "wholesale sales." Recall, IC 6-2.1-2-1(c)(1) states in part:

> "Wholesale sales" means any sale described in this subsection in which the purchaser is not a division, subdivision, agency, instrumentality, unit, or department of government:
>
> > (C) Sales of tangible personal property to be incorporated as a material or integral part of *tangible personal property produced by a purchaser in the business of manufacturing, assembling, constructing, refining, or processing.*
>
> (Emphasis added.)

Clearly, the concept of "wholesale sales" anticipates the production of tangible personal property by one claiming the "wholesale sales" exemption. The inclusion of the debated language of IC 6-2.1-2(c)(1)(D)(ii)—i.e., "by such person in the business of manufacturing, assembling, constructing, refining, or processing"—is also consistent with this notion. The Department, therefore, will not exclude the "manufacturing, assembling, refining, or processing" requirement from its definition of "industrial processing."

FINDING

Taxpayer's protest is denied.

III. Gross Income Tax — Interstate Sales

DISCUSSION

Taxpayer classified sales of computer software maintenance agreements as interstate sales. These sales were excluded by Taxpayer from its Indiana gross income. Proposed assessments resulted.

In the original LOF, the Department concluded, relying on IC 6-2.1-3-3 and 45 IAC 1-1-119, that Taxpayer's sales represented sales "made in interstate commerce;" as such, the sales should not have been included in Taxpayer's Indiana gross income. Taxpayer now asks the Department to clarify the scope of its findings. Taxpayer explains:

> Although the "Discussion" [from the original LOF] squarely addresses the issue, the "Discussion" and "Finding" do not exactly address all years for which adjustments are necessary…. 1991 was the only year the taxpayer classified these sales as sales made in interstate commerce . In fiscal years 6/30/90 and 6/30/92 the taxpayer erroneously did not exclude any of these sales [from its Indiana gross income] as sales made in interstate commerce.

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> We, therefore, request a rehearing to incorporate into the "Discussion" and "Findings"…adjustments…to taxable gross receipts for fiscal years 6/30/90 and 6/30/92 [in order] to exclude the gross receipts from sales of computer software maintenance contracts made in interstate commerce (emphasis added).

The Department, pursuant to IC 6-8.1-5-1, conducts hearings on timely filed protests of proposed assessments—as was the case for 1991. However, no proposed assessments were made in 1990 and 1992 because Taxpayer included these "interstate" sales in its Indiana gross income. Concomitant with its protest of these proposed assessments, Taxpayer requested a refund for taxes "erroneously" paid in 1990 and 1992. In other words, the 1990 and 1992 claims were based on overpayments of tax, not on proposed assessments. Given the statutory mandate regarding the conduct of hearings, the Department will not expand the language of its LOF to incorporate overpayments made in 1990 and 1992.

Taxpayer, however, is not without a remedy. Taxpayer's refund request will be evaluated consistent with the Department's previous findings; but any refund amounts approved may only be used to offset Taxpayer's outstanding tax liabilities (based on assessments) for 1990 and 1992.

FINDING

Audit did not propose assessments of sales/use tax on Taxpayer's interstate sales of computer software maintenance agreements in 1990 and 1992. Consequently, Taxpayer lacks an issue to protest. Findings, therefore, are not required.

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